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## NOTES AND MEMORANDA

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### THE WAR AND THE FINANCIAL SITUATION IN THE UNITED STATES

THE war in Europe immediately subjected the United States to severe financial strain, because this is a debtor country in the international short-time loan market as well as on account of more permanent investments of foreign capital. Unlike London, the New York money market possessed no resources the liquidation of which would serve to offset payment for the enormous volume of securities which were sold on foreign account on the New York Stock Exchange during the week preceding the outbreak of hostilities. Before these sales began, the New York money market was in its normal mid-summer position. The banks held a surplus reserve of about 26 million dollars — not enough to be of much use under a system in which the required reserves are never fully utilized, but still almost as large as at the same date in the preceding year and somewhat larger than in July of 1912. Foreign balances were at a low level and a considerable amount had been borrowed in London by means of finance bills anticipating the proceeds of the cotton and grain bills of the autumn months. Past experience warranted the feeling that this practice, in moderation, involved no serious element of weakness. All former periods of severe financial strain had been primarily the result of unsound domestic conditions; and by means of temporary loans and sales of securities, additional funds from foreign sources had always been forthcoming.

The prospect of a general European war, to say nothing of its outbreak, created an entirely novel situation. Foreign lenders and investors endeavored to liquidate American as well as other securities with little regard to the sacrifice entailed. Since it was impossible to secure new loans in Europe, every maturing bill of exchange or short-time note

as well as all sales of securities by foreign holders on the New York Stock Exchange involved payments which could only be made by the shipment of gold. In the course of the week ending Friday, July 31st, over 44 million dollars was withdrawn from the banks for export, and a vastly larger sum would have been taken if underwriters had been willing to insure a larger quantity. It is important also to note that most American purchasers of these securities sold on foreign account assumed the possibility of securing with them as collateral the accustomed accommodation from the banks. Accordingly the transactions which were leading to the rapid depletion of the reserves of the banks through gold shipments were also creating an increased demand for bank loans. During the week ending with July 31st the cash reserve of the New York Clearing House banks and trust companies was reduced by 56 million, and a surplus of 26 million was converted into a deficit of 17 million; there being at the same time a slight increase in loans, amounting to \$1,182,000.

Drastic measures of relief were imperatively needed. The first and inevitable measure was the closing of the Stock Exchanges of New York and of other cities. Since the stock exchanges of other countries were already closed, the continuance of dealings on the American exchanges would have concentrated the pressure of liquidation upon the particular issues of securities listed here, in which foreign capital has been largely invested. With the closing of the stock exchanges, the transactions which were creating the bulk of the indebtedness immediately payable abroad were no longer possible. But in resorting to this means of relieving the situation, a new difficulty was created for the banks. All collateral loans, both time and call loans, became permanent investments for the banks until the resumption of dealings on the exchanges. Obviously the payment of loans could not be insisted upon when there was no market in which either borrowers or banks could sell the collateral securing them. Additional security was provided by many borrowers; and in some instances loans were reduced or entirely paid; but the banks were not able to insist upon such action. In other

words, the particular variety of loans upon the liquidation of which the banks mainly relied as a means of increasing their free assets was in this period of strain a wholly unavailable resource.

In these circumstances it was inevitable that the banks of New York and other cities should resort to the familiar device of the clearing house loan certificate for the settlement of balances between themselves. These certificates, however, merely enable a bank to defer cash payments with other banks in the same clearing house; they do not enable it to meet payments due banks in other places. Indeed, the use of the certificates is altogether likely to make it necessary for the banks to restrict cash payments, since a bank weak in reserve, even if it has a favorable clearing house balance, receives certificates instead of cash.

As in 1873, 1893, and 1907, resort to the clearing house loan certificate would probably have led to restrictions on cash payments but for the Aldrich-Vreeland Act of 1908, authorizing the issue of emergency bank notes. This Act, which would have expired by limitation in July, 1914, was fortunately extended for one year by the Federal Reserve Act of 1913. At the same time, the tax on the notes was materially reduced from a minimum of 5 % to 3 % during the first three months of issue, thereafter increasing  $\frac{1}{2}$  % monthly until a maximum of 6 % is reached, contrasting with a maximum of 10 % according to the original act. The availability of these notes was still further increased by an act which passed through both houses of Congress on August 4th removing the requirement that no bank might take advantage of the act unless it was already issuing bond-secured notes to the extent of 40 % of its capital. At the opening of business in New York on Monday, August 3d, nearly 46 million of these notes were available, and a further supply was provided there and in other parts of the country as soon as the notes could be prepared and shipped. These notes have been generally used by the banks not only in counter payments to depositors but also in making settlements between banks in different places. They were also largely used instead of loan certifi-

cates in the settlement of clearing balances, because the tax on the notes was only 3 %, while the minimum rate of interest on the certificates is 6 % and in many cities 7 % or even more. The total of clearing house certificates was, therefore, smaller than on previous occasions. The amount outstanding against national banks on September 12, the date of the last return of the banks to the Comptroller of the Currency, was only \$52,779,000. The same return, contrasted with that of June 30th, showed an increase in the issue of bank notes of \$196,000,000. With these emergency notes the banks satisfied practically all demands for additional money for domestic use outside the banks, thus safeguarding their reserves, which between the two Comptroller's calls fell only \$65,000,000, not much more than the amount of money which was exported, and that deposited in the 5 per cent redemption fund in Washington. Thanks to the emergency notes, the banks maintained payments without restrictions in their dealings both with the public and between themselves. It should also be noted that the banks did not, as in all former crises, attempt to strengthen themselves by loan contraction. Between June 30 and September 12 loans and other investments increased \$307,000,000 or slightly more than four per cent, — a most satisfactory showing. It is a safe conclusion that, if similar notes had been available in former crises, the results would have been equally satisfactory. The dislocation of the domestic exchanges, the premium on currency, and the partial break-down of the check machinery of the country would have been avoided.

In thus relieving the banks from the necessity of using reserve money to meet domestic requirements, the issue of emergency notes placed the banks in a better position to meet the heavy foreign indebtedness already due on the first of August or maturing thereafter. The banks, however, exhibited no more readiness to allow their reserves to be used in meeting foreign payments than on former occasions when the withdrawals were for domestic purposes. From the beginning of August to the present time (October 27) gold payments were restricted. Quotations for demand sterling

were seldom below \$4.95, indicating a premium on gold of from one to two per cent. The course of our banks during former crises strongly suggests that the unwillingness of the banks to supply the gold necessary to restore foreign exchange to a normal level was not because gold rather than other reserve money would have been withdrawn. Whenever reserves have dropped very much below legal requirements, our banks have always restricted payments, if further withdrawals were threatened upon a large scale. In the past the demand has come from the western and southern banks. On this occasion it happened to be for the purpose of meeting foreign payments. We have here simply another instance of the uselessness, under the system soon fortunately to be changed, of the reserves of our banks when occasion for their use presents itself.

How much gold would have been taken for export if payments had been maintained cannot be determined. Estimates of the amount of indebtedness which became due offer no indication of the amount of gold which would have been required. Nearly all of the gold which might have been exported would have gone to London and by creating easier conditions in that market the possibility of securing new loans to take the place of maturing obligations would have been greatly enhanced. Moreover, foreign short-time loans to this market would doubtless have become more attractive, if we had shown a determination to continue cash payments, even in the midst of universal financial commotion.

Had the Federal Reserve banks been in full operation for a number of years, it is to be presumed that gold would have been furnished to satisfy all foreign requirements. It is probably fortunate, however, that the new banks did not begin business, as was originally expected, in June or July. While they might have been helpful, it is unlikely that they would have been able fully to maintain the normal course of banking operations. Partial failure to do so might have lessened confidence in the new system, and such confidence, it hardly need be said, is absolutely indispensable if it is to perform the functions for which it has been designed. The

fact that the system was not in operation at this time of crisis, sometimes declared unfortunate, was in reality a piece of good fortune.

The abnormal financial conditions abroad and the consequent extraordinary pressure for remittances from this country led to abnormal conditions in foreign exchange; nor can it be said how soon normal conditions will be restored. By means of a syndicate in which all the banks and trust companies of New York participated, arrangements were made in September to meet the largest single requirement for means of payment in London, — some 80 millions of New York City notes maturing at various dates between September and January. A gold pool of 100 million dollars, to which banks in the central reserve and reserve cities have subscribed in proportion to their present gold holdings, is now furnishing a certain amount of exchange against shipments of gold to Ottawa, where the Bank of England has opened a depository. These arrangements at first only served to steady the rate of exchange in the vicinity of \$4.96, but in conjunction with increasing merchandise exports and pronounced monetary ease in London they contributed to at least a temporary return to a normal exchange level in the last week of October. Should the present condition of monetary ease in London continue, it will doubtless be found possible to secure short-time credits there to take the place of a considerable amount of maturing obligations, in particular the numerous short-term railroad notes which are largely held in that market. It is interesting to note in this connection that London has already resumed to some extent the business of financing American foreign trade, both exports and imports. If, however, the course of events should bring on a long period of financial stringency in London, permanent normal exchange relations may be indefinitely postponed. A country which is heavily indebted to Europe is a passive agent in the present juncture and cannot control the forces which are disturbing its financial structure.

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